STRATEGIES, TRENDS AND NEWS FOR TODAY'S INVESTORS FEBRUARY, 2010

LUMBARD INVESTMENT COUNSELING

INSIGHT

Nasdaq Composite 2,317 * Dow Jones Industrials 10,618 * 30 year U.S. Treasury Bond 4.67%

FLEEING FROM THE SAFETY OF CASH

What every investor wants to know, these days, is how to get a better return on cash. Everybody on this planet is looking for a perfectly-safe short-term investment that pays 5%, so you can just forget about finding one. But is it too late to buy into bonds? How about stocks, commodities, or the Miracle of Free Markets in Asia?

Bonds have been extraordinarily good to us in the past year, and it's still easy to find safe 6% yields if you're willing to buy something that matures in 2025. The problem is that you'd be taking a big gamble on interest rates, because when rates rise, bond prices fall. We expect a surprisingly-cool economy and relatively-low interest rates in 2010, but we wouldn't want to place a heavy bet on that forecast. Most of the bonds we're retaining have adjustable interest rates, and low prices that reflect uncertainty about some issue—such as whether the government will continue to be willing to bail out Citigroup. The gummint owns 34% of the shares, so we doubt that anybody in Washington would ever have the courage to pull the plug . . . . .

Stocks are another matter. Here we're willing to take the long-term view, as long as we're talking about solid companies that pay large and growing dividends. Take, for example, Kimberly-Clark, (KMB - $62) a blue-chip company with a growing 3.9% yield and solid earnings growth that should allow you to sell your shares, three years from now, at your purchase price or better. What do panty bombers wear? Depends . . . .

Century Telephone (CTL - $34) pays an 8% dividend, and we think they'll be able to keep paying it despite the steady shrinkage of "plain old telephone service". The company has big earnings and an even bigger cash flow, and they'll use the extra cash to buy back shares at a rate that keeps earnings per share rising. AT&T (T - $27) offers a 6% yield and some genuine growth prospects that center around cellular telephones—which is one of those businesses where the big keep getting bigger.

The drug companies will survive health care reform, and the stocks are cheap. Johnson and Johnson (JNJ - $64, yield 3%) and Sanofi-Aventis (SNY - $39, 3.5%) have new drugs that offer an improvement over existing therapies. Patients are free to buy those drugs at high prices, or stick with the dazzling array of extraordinarily-cheap, ten-year-old drugs that go off patent every year.

Golar LNG (GLNG - $13) has run up a lot since we wrote about it, but the company should resume paying a $1 dividend in about 12 months. Gas will displace oil and coal worldwide, even as Iraq triples its oil production and the members of OPEC begin to cheat on their quotas. We've used exchange-traded funds (ETFs) to make small bets that the price of oil will go down, and that copper and other metals will also decline later this year when world economic growth slows down.

Lastly, we've invested in an ETF that tracks the appreciation of the Chinese Renminbi (or yuan) which should soon resume its

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FLEEING...

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slow rise against the dollar. It's been falling against the euro, and that's just ridiculous.

How about using that cash to pay off the mortgage? No—borrow all you can at today's 5% rate, even if you have to reinvest, temporarily, at 0%.

The answer to the cash question is to diversify the old-fashioned way. Seek out dividends and interest, wait for good prices, and avoid the herd. ■

A NEW TOY FOR CONGRESS

The entire Montana congressional delegation has joined hands in bipartisan harmony to force General Motors to buy palladium from Montana's Stillwater mine. GM took taxpayer dollars, so now Congress gets to call the shots!

Rep. Dale Kildee of Michigan insisted that GM and Chrysler use unionized trucking firms, at an additional cost of $10 million a year for Chrysler alone. Then there are the Senators and Representatives from all across this great land who have forced GM to reopen 70 dealerships . . . . . ■

ASK SINGAPORE

The 5 million people of Singapore live in an area of just 274 square miles. Water has long been imported from Malaysia (to whom Singapore was briefly married after independence), but the nation has implemented water conservation and recycling efforts that are the envy of parched cities around the world. All runoff from streets and sidewalks is captured for purification to drinking water, so littering and other forms of street-level pollution are rare.

Singapore has a highly-developed market-based economy that is regularly ranked as one of the most business-friendly in the world. Enormous reserves of foreign currency (and a large sovereign wealth fund) back the Singapore dollar and the thriving banking system. The nation's citizens have amassed substantial savings as well, partly through a social security system—with unusually-large mandatory contributions—which creates accounts that are fully owned by the workers paying into them.

Each citizen also has a health savings account (there are government subsidies for the poor), and the result is ***universal*** health care that runs on a free-market model. Patients shop for services while hospitals and doctors compete on price and patient care, in a system that is all about doctors and health care professionals (as distinct from insurance, bureaucrats, and paper pushers). Everybody has *skin in the game*, and the result is that Singapore's health care costs just 5% of GDP (versus 18% in the U.S. and about 11% in Europe). Her citizens live longer than Americans, and they live longer than Europeans.

The city-state is a financial center that is home to businesses that reach far across Asia. Our clients own shares of Singapore Telecom (SGAPY.PK - $21), which gives them a 4% yield and significant stakes in cell phone businesses in some of the fastest growing nations of the world—running in an arc from India to Indonesia and the Phillipines.

The nation's external government debt is zero. That's quite a contrast to what's going on here in the 'States, where we reward borrowing, foolish spending, red tape, and complexity, while penalizing hard work, savings, thriftiness, and simplicity. It's time we turned to Singapore for guidance. Former Prime Minister Lee Kuan Yew stands ready to help. ■

ILL-GOTTEN GAINS

Under intense pressure from the public, Washington is finally going to close *one* tax loophole. You'll remember that hedge funds charge 2%—much more than double our rate on larger accounts—and also take 20% of the gains in each client's assets. That's shocking, really, but the topper is that until now the richest hedge fund managers were taxed at just a 15% rate on that 20% slice. Of course, they had to buy protection every year with campaign donations, and it wasn't cheap . . .

10/10/10

The economy has strengthened, but don't expect to see 3% growth throughout 2010. Right now the Stimulus Package is stimulating the economy—don't even try to pretend it isn't—but when the stimulus stops the economy will deflate again.

And here's the part that many economists don't understand. *Consumers aren't going to go back to spending like it's 2005.* Brainless over-consumption was a herd phenomenon, just like the stock-market bubble, the real-estate bubble, and the various commodity bubbles. Retirement now looms for millions, and most Americans are fully aware that they can no longer run up credit-card bills and roll the debt into the mortgage.

A recession is a cleansing process. The problem for 2010 is that this one didn't do much cleansing. Most Americans still have all the debt they had in 2007, and the federal government has a lot more.

Let's face it; our economy was pumped up to greater size and faster growth by borrowing. It will take years of slow growth to get us back to "normal". And investors can't be encouraged by the fact that the outlook for the auto, housing, banking, defense, and health care industries—and just about every other industry—is largely dependent on government policy. Our forecast for **10/10/10** puts the Dow at **10,010**, the S&P at **1010**, gold at **1010**, and the unemployment rate at a nice round **10%**.

When someone asserts to you that the free market has failed and that we need a new model, point out that free markets didn't fail in Singapore. Or in Indonesia, Brazil, Australia, or China—which lacks democratic freedom, but has capitalist markets that operate so freely that most of us would like to see a bit more regulation . . . .

The countries that have struggled the most in the past year have been the Big Government nations. Portugal, Italy, Greece, and Spain (known to international bond traders as the PIGS); the United States; and Japan. Study Japan, because it's the very model of the modern major muddle. We're heading down that path right now.

The tax code is 16,845 pages long. We'd like to tell you how many pages of laws and regulations there are in total (it could easily—seriously—be a million), but you can't find that information via Google, Bing, or any other search engine. No one knows.

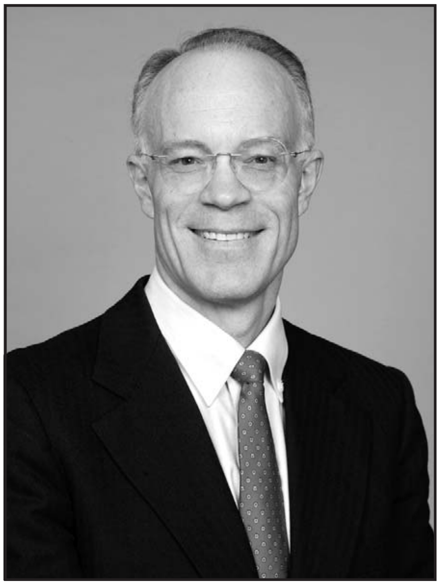
A trillion one-dollar bills, stacked one on top of another, would reach 67,866 miles.

There are 110 million households in the United States. If the federal government decides to give away a trillion dollars, the handout will be less than $10,000 per household. Pretty disappointing, in the wake of e-mails suggesting that the Congress should send each taxpayer a million dollars to get the economy moving.

Still, the situation looks very different when you suggest that each household will have to *pay* $10,000 to the federal government to help it pay back the money it borrowed in the last 8 or 9 months. If Congress borrows a trillion dollars a year in the next ten years, each household is going to have to pay $100,000 in taxes—on top of the taxes we already pay. Not to mention the cost of the interest on the debt, which will double and redouble as the debt grows and interest rates rise.

How 'bout pushing all the taxes onto the rich? Forbes says that the richest 400 Americans—**Bill Gates, Warren Buffett, Larry Ellison, the Wal-Mart Waltons, Michael Bloomberg, Michael Dell, the guys from Google, and 389 of their peers**—are only worth $1.27 trillion.

DEBT IS SLAVERY.
SAVINGS ARE FREEDOM.
SAVE 'TIL IT HURTS.



John Lumbard, CFA

"While I believe that the government can play an important role in creating the conditions for economic growth and employment, true growth and real jobs can only come from the private sector."

President Barack Obama,
December 3, 2009

— Senate Majority Leader Harry Reid, describing town-hall protestors of the health care bill.

"Government is the great fiction, through which everybody endeavors to live at the expense of everybody else."

– Nineteenth century economist
Frédéric Bastiat

SMALL IS BEAUTIFUL

Power Corrupts. And it breeds inefficiency, slothfulness, and waste.

Big banks are no better than big government, and lately the two have been working hand in hand. Two decades of bank mergers, followed by big-bank bailouts and little-bank bankruptcies, have left the consumer with few places to turn. The *2Big2Fail* banks are taking advantage, with a wink and a nod from Uncle Sam.

They're charging fees on long-closed accounts, hitting tardy credit-card customers with interest rates as high as **32%** (we've seen it, on bills to the elderly), and billing debit-card customers $35 a whack for overdrafts—on a debit card!!—that never should have been possible in the first place.

Never fear; Congress is on the case. Financial reform has been put in the hands of Christopher Dodd (who received sweetheart mortgage deals from sub-prime kingpin Angelo Mozilo) and Barney Frank (whose love triangle with Fannie Mae and Freddie Mac will cost $400 billion, or $3,600 per American household). Melissa Bean of Illinois (who received $1.4 million in campaign contributions from Wall Street) is also in the mix, but Frank and Bean haven't gone together as well as you'd think . . . .

The *right* way to reduce the risk in the financial system is to force the biggest banks to hold a lot of cash that is never lent out and never put at risk. They won't make as much money, but they'll be less likely to fail; and it won't be long before bankers—even the dim-witted ones—decide that they'd be better off if they weren't so very large. Decades of bank mergers would be undone, the 2Big2Fail banks would disappear (no more bailouts!), and consumers would be able to choose among a wide array of community-focused banks that are eager to serve them.

"The financial reform on the table is analogous to our response to airline terrorism (by frisking grandma and taking away everyone's shampoo), in that it gives the appearance of officially "doing something" and adds to our bureaucracy without really making anything safer."

– David Einhorn,
in <u>Outside the Box</u>

Nearly 10 million of the nation's 25 million subprime mortgage loans were guaranteed by (or on the books of) Fannie Mae and Freddie Mac. Another 4.5 million were guaranteed by the Federal Housing Authority . . . .

"I do think I do not want the same kind of focus on safety and soundness that we have in OCC [Office of the Comptroller of the Currency] and OTS [Office of Thrift Supervision]. I want to roll the dice a little bit more in this situation towards subsidized housing."

— Rep. Barney Frank,
Sept. 25, 2003

USA Today says that there are now 382,758 federal workers who earn more than $100,000, and that the average federal worker makes 77% more than the average worker in the private sector.

We can't possibly cover the cost of growing federal bureaucracies by taxing federal employees, and we can't pay for Medicare and Social Security benefits by taxing the elderly. We certainly can't pay for programs that fight poverty by taxing the poor. Taxes have to come from the private sector, and the private sector is shrinking while Washington grows.

Drew D. Kellner

QUINTUPLED (AND A HALF)

The decade that just ended—the Naughts—was the worst ten-year period for U.S stocks in history. Stocks actually declined a half a percent each year, and that's including dividends; over that period the S&P 500 dropped from 1,469 to 1,115.

In that time (Dec 31, 1999 to Dec. 31, 2009) our "Benchmark" account grew from $216,635 to $548,748. Up 153%, greatly aided by the fact that it declined just 3.3% in 2008. Sure, it's a small account (it opened at a value of $100,000, not long after we opened our doors with absolutely nothing under management), but it's invested without favoritism alongside our largest portfolios. It has the same holdings and the same low brokerage commissions, and it pays a fixed 1% fee that accounts for the only withdrawals or additions the portfolio has seen in 19 years.

You can find the performance of our larger accounts on our website (www.Lumbard.com). The numbers are compiled by our custodian U.S. Bank, which is arguably one of the two strongest banks in the nation. Terry Schwartz, our relationship manager at the bank, can be reached at (513) 632-4992. And please call us for additional information—don't forget to ask for a Form ADV Part II (!!)—at (800) Lumbard. The digits work out to (800) 586-2273. ■

FREE AT THE SCOOTER STORE!

Uncle Sam is giving away free motorized scooters to seniors, at The Scooter Store! If you're too young for that free handout, you're still eligible for a $5,300 tax credit towards an $8,000 golf cart. Normally you have to keep the cart for 27 months before you're allowed to sell it at a big profit, but "The Golf Cart Man" of Lady Lake, Florida will be happy to sign a deal today that will allow you to "make $2,000 doing absolutely nothing."

Then there's an offer (to low-income voters, on the eve of the 2010 elections) of free Motorola cell phones with all the bells and whistles: *"Any Minutes you do not use will roll-over. Features such as caller ID, call waiting and voicemail are all also included with your service."* You only get 68 free minutes a month—an additional 60 minutes costs $20—but you get "text, international calling to over 60 destinations . . ." TracFone spokesman Jose Fuentes says that "Over one million households in Illinois qualify . . ." ■

TOO BIG TO FAIL IS TOO BIG

TAKING BACK THE CONGRESS

"To deliver on all the government's obligations and promises we'd need $175,000 per person right now." –The Concord Coalition

That's **$53 trillion**. It includes both the existing debt and the future unfunded cost of entitlements such as Medicare and Social Security.

Bashing BushObama might be our national pastime, but it's the Congress that runs the country—most particularly the nation's budget. With a 2/3 majority the Congress can overrule the President on just about anything. And many congressmen now state openly that their job is to get as much taxpayer loot as possible for their constituents, even if it means that we all run headlong, like lemmings, over a cliff and into bankruptcy.

"Kicking The Bums Out" isn't going to work, at least not for long. But way back in 1994 the U.S. Congress came within a single vote of passing a **balanced-budget amendment to the Constitution,** and *succeeded* in putting a **line-item veto** into law. That law wasn't worded carefully enough to pass muster at the Supreme Court, but today our own Senator Judd Gregg is pushing hard for a better version. It's a wonderful leap towards sanity, but to *reach* sanity—actually balance the budget—we're also going to need that amendment to the Constitution.

The constitutions of most states *demand* balanced budgets, and in fact 49 of the 50 states are guided by language to that effect. We'll need to make allowances for wars and recessions, but all the proposals we've ever seen have done so. Some day we'll look back on the current practice—allowing Congress unlimited use of our credit cards—and think that it was a risky and lunatic way to operate.

As long as We The People are taking back control of our Congress, we should also insist on **term limits**.

Washington is full of lifetime politicians who maintain their grip on power by showering money on their constituents. They're buying votes with your money.

We want **a tax system that's fair and simple**—so simple that nobody can manipulate it to their advantage. And we should **limit government spending** to the levels we had when we last had a balanced budget, back in the Clinton years. Federal spending in the year 2000 was just 18.4% of GDP. We'll round it up to 20%, splitting the difference between 2009 taxes *(15% of GDP)* and 2009 spending *(nearly 25% of GDP)*.

What we need now is a simple platform that can be used by congressional candidates from both parties in the coming elections. Send us your ideas. If 25 sober and coherent citizens respond, we'll set up a web site to discuss proposals and provide a rallying point. We've already reserved a web address: WeElectedYou.org.

It's a lot to hope for, but let's never forget that we're borrowing huge amounts of money from our children. How can anybody ignore that simple fact, and continue to steal money from his sons and daughters?

John Lumbard, CFA
john@lumbard.com

Barbara Boxer is in bed with Boeing. The same can be said of most of the California and Washington delegations (and Chris Dodd), but we like the alliteration . . . . . In recent weeks they all joined forces again to force the $2.5 billion funding of ten gigantic C-17 aircraft, over the strenuous objections of the Pentagon. And if you like that story, check out the Darleen Druyan scandal, or the re-bidding of the air tanker contract won by Northrop. We sold our shares.

"It may please you or it may not please you. I'm the Number One earmarks guy in the U.S. Congress."

–Senator Daniel Inouye.

Many of Inouye's earmarks are for defense appropriations that the Pentagon opposes.

Performance Results:

The performance results presented below are for our "Benchmark Account", using January 1, 1998 as the date of inception. The performance results for the Benchmark Account are calculated by Lumbard & Kellner, LLC's current custodian, U.S. Bank (prior to 2004 State Street was the custodian). The account pays fees based on our firm's fee schedule from the 1990s (top rate of 1%), and the percentages shown are net of fees and expenses—that is, the returns shown would have been higher if fees had not been deducted. The performance results for the Benchmark Account include the reinvestment of dividends and other earnings, but there have not been any other additions or withdrawals since inception. The comparative indexes shown are the S&P 500 Composite Index, Dow Jones Industrial Average, NASDAQ Composite, Barclays U.S. Aggregate Bond Index, and the Citigroup 3 Mo T-Bill Index.

Actual returns for individual client portfolios managed by Lumbard & Kellner, LLC may vary and will not necessarily coincide exactly with the returns for the "Benchmark Account." Past performance of the "Benchmark Account" does not guarantee future results. No assurances or guarantees can be given or implied concerning future investment results for Lumbard & Kellner, LLC or any investment index. Future returns may differ significantly from the past due to materially different economic and market conditions and other factors. Investments within portfolios, and therefore, portfolios, involve risk and the possibility of loss, including a permanent loss of principal.

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